

# **EFFECTIVE TENDERING IN INTERNATIONAL COAL MARKETS**

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# **Effective Tendering in International Thermal Coal Markets**

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## **Abstract**

With the introduction of competition into the electricity industry, utilities are trying their best to secure coal at as low price as possible. In the past the fuel cost could be passed on to consumers but now it directly affects the company's profit. Therefore, utilities cannot sit on long-term contracts and stick to quality coal for technical purposes any longer. Competitive tendering is becoming dominant to achieve more economic viability. Effective competitive tendering boosts competition among suppliers and minimize supplier's risk. To prepare the effective tendering, a team conducting the tender has to thoroughly consult with all the related internal customers. To enhance competition we can allow multi-sourcing and let traders participate. To minimize supplier's risk we can make a good contract, build up credibility or adopt some indices for price negotiation. Internet reverse auction could be also a good way to the effective tendering.

## **Changes in Coal Procurement Policy in KEPCO**

Around 37% of the world's electricity are based on coal. Korea lacks indigenous energy resources. Dependence on imported fuels can make a nation vulnerable to shortages. This risk is greater if these resources are concentrated in only one or two areas of the world. Korea relies on coal for a major part of its energy needs. Coal has geographic diversity of reserves and security of imports.

Back in the 1960's, KEPCO's operations were heavily dependent on hard coal-fired (domestic anthracite) and hydro-electric power. The system was then transformed to primarily oil-fired power plants in the 1970's and the dependency on oil reached 77.3% of total operations in 1975. The steady diversification plan of KEPCO's fuel source which has been implemented since Korea experienced energy crises in the 70's, has resulted in the construction of more nuclear and coal-fired power plants and now in Korea coal-fired power plants take around 30% of the whole generation capacity. In addition to the merit in terms of the stable fuel procurement, the economical viability has made the generation companies highly dependent on the coal-fired power plants.

With a background as the monopoly generator, transmitter and distributor in Korea whose majority equity interest is owned by the government, KEPCO has been oriented toward stability rather than economic competitiveness. On top of this, Korea is vulnerable to changes in the world resources market due to insufficient domestic supply of natural resources. Therefore, until the early 1990s KEPCO had no choice but to depend entirely on long-term contract procurements whose contract period was 10 years. At that time once a long-term contract was concluded through individual negotiations it has been considered to be evergreen. When the contract period expired, it was renewed through negotiations.

Since the middle of the 1990s KEPCO began to place emphasis on economic procurement. Contract periods were shortened to 5 years and even 1 year in some cases and the competitive tendering was introduced. The proportion of quantity from the spot market has grown from 4% (0.8million tons) in 1997 to 32% (over 10 million tons) in 2000.

As of April 2, 2001 the generation facilities of KEPCO were split into 6 generation companies in accordance with the government's plan to introduce market focus into the electricity industry. The purpose of restructuring is to enhance efficiency through competition. As a result, with regard to the fuel procurement policy, Korean generation companies (Gencos) are trying their best to attain the most economically efficient procurement fuel which takes around 60% of generation cost. It is expected that from now on Gencos will no longer simply renew the existing long-term contracts when they expire. Gencos will try to utilize the competitive tendering instead. And as far as spot prices are lower than long-term prices, Gencos will want to take advantage of the spot market increasing spot quantity by exercising option which is plus or minus 20% to 30% of the long-term contract quantity. Procuring coal from the spot market is also to be done through competitive tendering.

## **Effective Tendering**

The aim of competitive tendering is to promote fair and open competition so that the best value for money is obtained. Good tendering practice requires us to apply the following key principles:

- ensuring that the competition process is conducted, and is seen to be conducted, in a fair and transparent manner
- adopting clear procedures for evaluating tenders to ensure that the required quality can be achieved
- acting fairly among potential contractors to ensure that the conduct of tendering does not put any one of them at a disadvantage

However, besides the above general principles I would like to point out just a few points, which I believe are very basic concepts but very important to make the tendering effective based on my experience in KEPCO and Gencos.

The main purpose of tenders of Gencos is to get the lowest price in the open market under given situations. The expression of given situations means restricted conditions where tenders have to be conducted. Factoring in infrastructure variables, there are four kinds of coal markets among our gencos: one for their dedicated vessels and the other without any obligations. Coal for the dedicated vessels requires suppliers from Australia, Canada or South Africa, which are located far from South Korea and can accommodate cape-sized vessels. This market can also be divided into two cases: one for power stations with desulphurization facilities and the other for power stations without desulphurization facilities. Gencos need coal with low sulphur content for their power stations that lack these facilities.

In general, I have found that the prices for those with limitations on the dedicated vessels and the sulphur content were the highest and the prices for those without any limitations were the lowest. Logically, without any limitations competition among suppliers will be enhanced the most. Now we can reach a conclusion which is self-evident in nature: The more competition among tenderers, the better results buyers can get.

In general cases there is a tradeoff between the lowest price and the reliability in terms of quality and performance. The lowest price can result from the minimum limitation and the reliability can be achieved by way of placing the limitation designed for a certain purpose a buyer is aiming at.

For instance, to secure coal with good quality from reliable suppliers, a buyer can prefer suppliers who have had experience dealing with the buyer. By means of this kind of limitation on the qualification of suppliers the buyer can get exactly what he wants at the cost of lower prices he can get otherwise. On the other hand he can secure quality coal which can meet all the conditions of power stations in question to

optimize and can keep the efficiency best. In addition to that, he can avoid some critical damages related with problems in quality or delivery which might be caused by unknown suppliers.

When it comes to tradeoff, it can be said there is no right answer but the decision entirely depends on one's perception on situations and his strategic consideration. But reflecting market changes into tendering systems we can find a better way for effective tendering instead of the tradeoff.

In Korea, gencos generally do not allow multi-sourcing. It means they only accept coal from a single mine in order that a certain quality of coal may be guaranteed. On the other hand, gencos prefer mine owners to traders to secure reliable performance. I personally believe that with development of experiences and skills in blending coal, the restriction on the multi-sourcing will be lifted in the near future. And as the world coal industry has become mature and traders are so active that they can develop a new dimension of competition, allowing traders to participate would make the tendering more effective. Considering such changes in the market and lifting up the restrictions on the multi-sourcing and traders, we can enhance competition further without corresponding risk in the tradeoff. In addition to that, suppliers can also get benefits from increased security of supply by way of diversifying risks across supply basins.

Another critical point to make tendering effective is to minimize suppliers' risk. Placing such risk on suppliers will affect the price that has to be paid to the suppliers. Logically, it will move the price upwards. Placing the burden on suppliers more than necessary means buyers have to incur more cost than necessary.

Contract terms and conditions should be clear and precise but not unnecessarily arduous. If any supplier feels tied to an over-rigorous contract, he may well be tempted to cover the risk by increasing the price.

Another way of minimizing suppliers' risk is for a buyer to build up and maintain its own credibility in daily business with suppliers. Otherwise, theoretically it is possible for suppliers to evaluate each buyer's risk and reflect some different risk premiums into prices they propose.

Getting rid of uncertainty in the future business is also a good way to minimize suppliers' risk. In tenders for long-term contracts by Gencos, suppliers have to compete on the first year price and for the prices of from the second year on they have to negotiate with buyers. Last year since the first introduction of competition into the electricity market in Korea, some suppliers might have suffered from difficulties in reaching an amicable agreement. As Gencos enter into the era of real competition from this year these difficulties are very likely to get more serious. Therefore, it would be a good idea to adopt some indices for price negotiation and avoid the counter-productive disputes in order that suppliers may not worry about any risk in future negotiations.

Nowadays we think of Internet reverse auctions as an alternative to the traditional blind tender. Is it an effective way? In line with the Internet era, the new type of trade utilizing Internet technology, E-marketplace, affects coal procurement. The uncertainty and fluctuation in coal consumption stemming from trade of electricity in the power exchange market will require faster turnover of coal procurement contracts which cannot be covered by the traditional system. The emergence of the electricity trading market will inevitably be accompanied by complicated derivatives to hedge the risk from uncertainty of generation, fluctuation of fuel price, etc. Both buyers and sellers will need a place where demand and supply can be settled faster than the past.

However, in Korea coal-fired power plants take base-load generation and they do not experience any serious uncertainty or fluctuation in coal consumption. In that sense it seems that it will take some time for e-tender to be activated in Korea. However, Internet reverse auctions can still be an effective tendering even in the current situation. The success of the Internet reverse auction depends on the extent of competition. If there are more than two tenderers who are really eager to win the contract, they can go down cent by cent in turns and reach far below a price level that they intend. However, if there is only one bidder who is really serious in getting the contract by all means while his competitors in the electronic tender are not as eager, the Internet reverse auction may not be effective because the aggressive bidder may not submit a much lower price because he can see the last posted price of his competitors when the Internet reverse auction is taking place. In which case, the price the aggressive bidder would finally submit would not be as low as he would otherwise have offered in a traditional blind tender. Korea East-West Power Company (KEWESPO) conducted the internet reverse auction for the first time in Korea at the end of last year. The result was very successful because there were two real competitors.

## **Conclusion**

The most effective ways of making the tendering effective are to boost competition among suppliers and to minimize risk from the suppliers' point of view. From the beginning a tender should be well prepared to induce maximum competition and minimize suppliers' risk. In order to do so a buyer should set up its target – lowest price or reliability and then to what extent. To set up an effective target a team conducting a tender has to sufficiently consult with internal customers - people in technical divisions, operators in local power plants, people in charge of coal stock management and any other people engaged in any business related coal.

The result of effective tendering can become more fruitful by developing the relationship between supplier and buyer into a partnership.

Finally, I would like to suggest a new way of tendering which I call "subjective tendering". A buyer shortlists coal suppliers who the buyer believes to be suitable and competitive and requests them to submit their proposals. It may seem to be similar to a restricted tendering. What is unique in the subjective tendering is that suppliers are requested to propose whatever they may want the buyer to consider. The buyer can set some conditions fixed such as quantity, contract period or whatever he wants or nothing depending on his needs. The merit of this method is, I believe, buyers and suppliers can find many points to develop to mutual satisfaction. In general business cases, it may be right that what gives earnings to one is very likely to cause loss to the other. However, if we start from the very beginning and try to find some ways to make a good contract which appreciates both supplier's needs and buyer's needs and satisfies common desires, the results can benefit both parties.

# Effective Tendering

- in Int'l Thermal Coal Market -



# Contents

- Changes in situation and policy
- Effective tendering
  - General principles
  - Empirical points
  - New ways of tendering
- Conclusion

# Changes in Circumstances(Kepco)

- Lack of natural resources
- Heavy dependence on domestic anthracite
- Turned to oil-fired in 70s(economic growth)
- more nuclear and coal(oil crises)
- Now, 30% of generation capacity
- Restructuring of Kepco -> competition  
-> emphasis on cost -> economic procurement

# Changes in Policy(Kepco)

<Then>

Long-term Contracts(10yrs)

Term Contracts

Nego or Renew

[Stability]

<Now>

Short-term Contract(1 or 3yrs)

Spot Increasing

Tendering

[Economy]



Progress of restructuring

Developments of market and Tech

# Effective Tendering

## - General Principles -

- Competition in a fair & transparent manner
- Clear procedures for evaluating tenders
- Fair action between potential contractors
- \* To promote fair and open competition
  - > Best value for money

# Effective Tendering

- Empirical Points -

**<Competition(1)>**

**Sulphur**

Medium	High
Low	Medium

**0**

**Cape**

# - Empirical Points -

## <Competition(2)>

- Trade-off
  - Price vs Reliability
  - a general case : limitation on qualification
  - Kepco case
    - multi-sourcing
    - traders

## - Empirical Points -

### <Risk>

- \* Higher risk, higher price
- Clear & precise contract terms & conditions
- Credibility
- Certainty in future business
  - Price negotiation

- New ways -

## <e-Tender : Reverse Auction>

- New circumstances
- Need for e-market place
- Current situation around Kepco
- Key for success
  - Competition
- KEWESPO case

- New ways -  
<Subjective Tendering>

- Shortlist suitable and competitive suppliers
- Set conditions as buyers want
- Request suppliers to propose whatever
- Find and develop points to mutual satisfaction
- Enjoy merits of both tendering and negotiation

# Conclusion

- Changes in circumstances and policy
- Effective tendering
  - to enhance competition
  - to reduce risk
- Alternatives to traditional ways
  - e-tender & subjective tender
- Good preparation : enough internal consultation